

Leveraged Investment Strategies and Interest Deductibility

When considering a traditional leveraged investment strategy in which one borrows funds to purchase investments, it is critical to understand the potential risks involved. First and foremost, be aware that both investment gains and losses are amplified, and while your investments could decrease in value, your obligation to repay the loan and related interest costs will remain. For this reason, this strategy is best suited to knowledgeable investors who already have a strong foundation of wealth and financial stability. In particular, investors using leveraging strategies should have the ability to service debt payments from regular cash flow (separate from any returns of the underlying investment portfolio) and can withstand possible increases in interest costs from the current low borrowing rates.

Strategies that could help reduce the inherent risks of leveraged investing, include:

- investing for the long-term; since the risks of leveraged investing decline with time;
- making blended principal and interest payments against the loan; and
- maintaining a diversified and disciplined investment strategy rather than following trends.

Interest deductibility for tax purposes

In considering leveraging investing strategies, it is also important to determine whether or not the interest on the debt will be deductible for income tax purposes, as a means of reducing the after-tax cost of borrowing.

The general requirement for interest deductibility for tax purposes is that the current and direct use of the loan proceeds must be to produce income, such as interest, dividends, rent or business income. As such, a direct link is required between the loan proceeds and a current (deductible)

use for the funds. In the context of investing, ideally the loan would be undertaken and the loan proceeds immediately invested in securities that return interest or dividends and that a paper trail be created to trace this link. It's important to note that the deduction for interest costs in the tax legislation limits the deduction to a 'reasonable' amount and requires an income-producing purpose for either property or business income. A separate provision in the tax legislation explicitly states that capital gains are not property (or business) income. As such, a strict interpretation would deny a deduction for interest costs where an investment produces only capital gains. However, the administrative policy of the Canada Revenue Agency (the CRA) typically allows an interest deduction on the purchase of common shares (or mutual funds), for example, if there is a reasonable expectation at the time of acquisition that the shares will pay dividends.

Re-financing (Debt swap)

Many tax practitioners recommend re-arranging one's financial affairs to potentially convert interest on a non-deductible personal debt into tax-deductible interest through an investment loan. This result could be achieved by restructuring debt so that the use of borrowed funds is directly traceable to an income-producing investment purpose.

A basic re-financing strategy involves the sale of some or all of an existing non-registered investment portfolio to use the cash proceeds to purchase a personal asset (such as an automobile or principal residence), or pay off a personal debt for which the interests costs are not currently deductible for tax purposes (e.g., home mortgage). Subsequently, a new investment loan would be established and all of the loan proceeds would be directed towards the re-purchase of the investment portfolio. Care must be undertaken in determining the tax implications of selling the investment portfolio (e.g., realization of

capital gains), reviewing potential superficial losses upon the repurchase of similar securities and structuring the transactions appropriately to achieve deductibility of interest for tax purposes. In general, a delay of at least 30 days before repurchasing is necessary to avoid the possible application of the 'superficial loss' rules; however, some practitioners may recommend a longer grace period to enhance the validity of the transactions undertaken.

Other considerations

When considering the income tax deductibility of interest, it's important to note the following:

- Because the annual income earned in a registered plan (e.g. TFSA, RRSP) is not taxable, interest paid on funds borrowed to contribute to a registered plan is not deductible for tax purposes;
- The nature of the security used as collateral for the loan is not the important factor – rather it is the **use of the borrowed funds** that determines the tax deductibility of the interest on the borrowed funds;
- Interest may be deductible when paid or payable (on an accrued basis) pursuant to a legal obligation, except for 'compound' interest (i.e., interest on interest), which is only deductible in the year it is actually paid; and
- In Quebec, an additional legislative requirement generally limits the deductibility of investment expenses to the amount of investment income earned each year.¹

Best practices

When initiating a leveraged borrowing strategy, consider the intended use of the funds and wherever possible, seek to ensure that borrowed funds are used for income-producing purposes to achieve interest deductibility in order to reduce the after-tax costs of borrowing. When available, excess funds could be used to pay down non-deductible personal debts (such as RRSP loans, mortgages on home purchases and credit card balances). For existing borrowings, be sure to maintain an ongoing link between the funds and an eligible income-producing purpose.

Finally, in addition to understanding the potential risks of leveraged investing, be aware that the tax deductibility of interest continues to be a contentious and complex area of taxation which often involves a degree of uncertainty in light of changing tax legislation, evolving case law and the CRA's interpretations. As such, investors should speak with their BMO Wealth Management professional to determine their suitability for leveraged investing, and consult with their tax advisor prior to implementing any transactions designed to achieve interest deductibility in order to fully understand all possible tax (and other) implications and to structure and document any planning appropriately, for their particular situation.



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¹ Quebec taxpayers should consult with their tax advisor for specific details regarding these additional provincial restrictions.

Note: Using borrowed money to finance the purchase of securities involves greater risk than a purchase using cash resources only. If you borrow money to purchase securities, your responsibility to repay the loan and pay interest as required by the terms of the loan remains the same even if the value of the securities purchased declines. For additional information, please review the IIROC Borrowing to Invest Investor Bulletin : http://www.iiroc.ca/investors/Documents/borrowingtoinvest_en_final.pdf

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